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TAGS: EFIN ECON PGOV TU
SUBJECT: CURRENT ACCOUNT DEFICIT CONCERNS: MITIGATING FACTORS AND A BAD SCENARIO

REF: A. ISTANBUL 1371

¶B. ANKARA 5637

¶1. (Sbu) Summary: As Turkey's current account deficit continues to grow, several analysts have recently outlined some mitigating factors that could reduce the danger of a disruptive correction. These factors include: Durables import growth is unlikely to continue to surge; short-term portfolio investors have shown a willingness to maintain their positions during sell-offs; and there are signs of growing Foreign Direct Investment. Despite these mitigating factors, other analysts point out the possibility of a bad scenario arising from good news on EU accession: short-term portfolio flows would continue to increase, inflating the currency and exacerbating the current account deficit. Even in this scenario, however, no analyst in Turkey believes there is a serious risk of a "maxi-devaluation" as some external analysts have suggested. End Summary.

¶2. (Sbu) Economic analysts tend to see the single greatest financial risk to the Turkish economy over the coming year or two as the risk that the build-up in the current account deficit could lead to a sudden, disruptive market correction in which the Turkish lira falls precipitously and short-term portfolio investors head for the exits. In recent weeks, however, several analysts have mentioned factors that mitigate against this scenario, or at least would limit the extent of the disruption.

Consumer Goods Import Surge Mainly Autos:

¶3. (Sbu) Both Memduh Akcay, Director of Foreign Economic Relations at the Turkish Treasury, and Mehmet Simsek of Merrill Lynch/London, told econoffs that they believe the surge in durable imports is unlikely to continue at the same pace. Akcay pointed out that when durables (especially cars) are excluded from consumer goods imports, this category of imports has hardly grown at all in 2004. Note: Economists' worries about import growth focus on consumer goods imports, on the theory that capital goods imports--which grew 76% in the first seven months of 2004 compared to the same period in 2003--are a proxy for investment. Unlike these two fast-growing categories, intermediate goods imports have shown only modest growth. If one assumes the boom in car sales is likely to taper off (see below), Akcay's point is that the growth in consumer goods imports should not be a cause for worry. End Note. In a similar, if less specific vein, IMF resrep told Econoffs that the IMF's GOT interlocutors view the current account deficit as largely self-correcting, perhaps for the reason espoused by Akcay. He added that IMF staff believe the GOT officials are at least partially right about the self-correcting nature of the current account deficit, but are considerably less sanguine.

¶4. (Sbu) Central Bank data suggests Akcay may be right: for the first seven months of 2004, motor vehicle and vehicle parts imports grew 173 percent, increasing by $3.8 billion, roughly equating to the $3.99 billion increase in total consumer goods imports. With tax incentives on turning in old cars to buy new ones now halved, and due to expire by year-end, Akcay went on, the auto sales growth should slow down. Simsek of Merrill Lynch, a more independent analyst than Akcay, made a similar point, noting that much of the demand for durable goods is pent-up demand from the crisis and immediate post-crisis period, and consumers rarely buy more than one car or refrigerator every few years, such that the growth is likely to taper off. Indeed, Auto Association data shows some tapering off, with monthly domestic auto sales having peaked in April and declining each month thereafter. In July, domestic retail car sales fell 7.2% while sales of imported vehicles fell 11.3%. Trade balance data for August, released by the State Statistical Institute on September 30, seem to confirm the trend, with vehicle and parts imports further declining 20% month-on-month, though some of this decline could be attributable to seasonal

factors. Simsek added, however, that another scenario cannot be excluded: if a continued fall in interest rates makes durable purchases affordable to a broader group of consumers the durables growth could continue.

"Hot Money" Is Really Lukewarm:

¶5. (Sbu) Another potential cushion against a steep fall in markets is the behavior of short-term foreign portfolio investors. Baturalp Candemir of HC Istanbul said that in the April-May sell-off, foreign investors did not try to completely liquidate their positions in Turkish lira assets, preferring to maintain a large portion of their holdings and hope that markets would come back. According to Candemir, investors simply did not want to incur large losses in a rapidly falling--and illiquid--market when there was a reasonable chance that Turkish bonds and bills would come back up in price. For this reason Candemir does not expect a market correction to turn into a rout under all but the most extreme circumstances. Ann Wyman of Citigroup's London office made a similar point: the investors who have pulled out during sell-offs are the ones who have lost money in Turkey. Even people who were holding Turkish assets in the crisis made money if they held their positions rather than selling.

Signs of Foreign Direct Investment:

¶5. (Sbu) A third factor that would mitigate against an alarmist current account deficit scenario would be an increase in Foreign Direct Investment. Though FDI continues to be far below Turkey's potential or the flows for comparator countries--there are signs of an increase from previous years. Central Bank balance of payments data show FDI of $1.3 billion for the first seven months of 2004, compared to $344 million for the first seven months of 2004. There is also considerable anecdotal evidence of corporate plans to expand capacity, particularly with GDP growth now expected to reach something on the order of 10 percent for 2004, and remain strong in 2005.

¶6. (Sbu) Though it may not be traditional FDI--in the sense of foreign corporate equity investment in Turkey--there is another line in the capital account suggesting there has been a surge of long-term capital flowing into Turkey's private sector. Both Kubilay Cinemre of Garanti Bank and Emin Ozturk of Bender Securities, drew econoffs' attention to the surge in non-bank private sector long-term borrowings in the balance of payments statistics. This category jumped from a negative $155 in the first seven months of 2003 to a positive $3.13 billion in the first seven months of 2004. Ozturk and Cinemre both felt this was an indicator of Turkish companies borrowing offshore to finance investments. (Note: Other Istanbul bank contacts pointed out that the Turkish tax code makes it attractive for Turkish banks to use offshore subsidiaries to lend to Turkish borrowers. The risk associated with foreign borrowing by Turkish corporates was not addressed by Ozturk and Cinemre. If the increase in this line item represents local corporates taking on additional foreign exchange risk through external borrowing, this would be an increase in vulnerability. If on the other hand, Turkish corporates foreign exposure is hedged through a stream of exports or through hedging instruments, then it is less of a concern. End note.)

How Good News Could Lead to a Bad Scenario:

¶7. (Sbu) Though the factors cited above may cushion the risk of a sharp correction, some economists see a danger that these factors could be offset by "too much" good news. Both Emin Ozturk and a visiting Fed economist laid out a scenario in which good news on the EU accession front, and possibly the IMF negotiations, leads to a surge in short-term portfolio investment, essentially the "convergence play" on EU accession. Under this scenario, this increased flow would exacerbate the overvaluation of the lira, causing even more consumer goods imports, and leading to an even more dramatic build-up in the current account deficit. Under this scenario, the correction, when it comes, would be that much more violent. But even in this scenario, Ozturk doubted there would be a depreciation as steep as 40 or 50%, and he thought such a correction would be manageable. None of the four Istanbul analysts at a recent roundtable discussion with econoffs, nor any other local analyst post is aware of, disagrees with Ozturk on this. In other words, they do not subscribe to the "maxi-devaluation" scenario suggested by a Moody's analyst and at least one U.S.-based emerging market analyst.

¶8. (Sbu) Comment: The behavior of markets over the past year, and comments by investment advisors like Wyman, give credibility to Ozturk's scenario, in that foreign emerging

market investors simply cannot afford to be out of a market like Turkey's high-yielding lira-denominated bonds, unless they expect a major crisis leading to default. In a sense, this is the flip side of Baturalp Candemir's observation about short-term investors not running for the exits in a correction. These investors' bias towards towards staying in could exacerbate the overvaluation/import surge problem.

EDELMAN